



May 2011

Investment Overview

INDEX

	Page
Golden Rule.....	1
Key Seed Fund Rules/Guidelines.....	1
The Government’s Seed Fund Mandate.....	2
“Eligibility” Requirements.....	3
Overview of Key SCIF Deal Criteria.....	5
Types of SCIF Investment Transactions	7
Deal Flow Diagrams	8
SCIF Deal “Eligibility Certificates”	9
NZVIF Investment Committee Process.....	9
Industry Standard Investment Documentation.....	11

This Investment Overview gives a summary of how the Seed Co-investment Fund (also referred to in this Overview as the Seed Fund or SCIF) operates and of the main considerations for SCIF partners when they are looking to involve the Seed Fund in a new (or follow-on) investment opportunity.

Our aim is to ensure that all of the information contained in this Overview is kept up to date. As such, we encourage partners to download and review this document directly from <http://www.nzvif.co.nz/seed-co-investment-information.html> on a deal by deal basis to ensure that they have the most relevant information on hand.

Golden Rule

Engage early with the SCIF team as soon as it is felt that it is likely that an investment will be made (whether it be initial or follow-on), and in particular in relation to any of the key deal criteria listed below. Notify us of any concerns and openly provide any information that could be relevant to the investment.

The exact timing of the initial (and then ongoing) engagement with SCIF will always depend on the facts of a particular deal but sooner rather than later is a good general rule.

Key Seed Fund Rules/Guidelines

There are two key sets of rules that guide the operation of the Seed Fund:

1. An investment mandate from Government that includes:
 - a. limits on the amounts that can be invested in individual businesses; and
 - b. “eligibility” rules in relation to the investment stage (the business must be at a seed or early stage in terms of its stage of development), the location of the business (the New Zealand “nexus” test) and industry type (the business must be operating in an “eligible industry”).
2. “In-house” investment guidelines and practices developed over time by the New Zealand Venture Investment Fund (**NZVIF**) management team and NZVIF's Investment Committee.

The Government's Seed Fund Mandate

INVESTMENT LIMITS

The key investment limits are:

- a. Total Co-investment per Partner: There is a limit of \$4.0 million in aggregate for all co-investments with any one SCIF partner. SCIF also has limited discretion to invest up to an additional \$4.0 million (up to a total of \$8.0 million) once that initial \$4.0 million has been invested; and
- b. Total Co-investment per Company: The total **initial** amount which SCIF can commit for co-investment in a single company is the lesser of:
 - i. \$250,000; and
 - ii. The amount committed by the relevant SCIF partner in the same investment round (i.e. the Seed Fund will only "match" investment by the relevant partner dollar for dollar up to a total Seed Fund initial investment figure of \$250,000).

After this initial investment, SCIF has the ability to participate in "follow-on" investments in the same investee company for a further \$250,000 – and so up to a total investment limit of \$500,000 per company.

While no minimum investment amount applies, SCIF will usually only consider a co-investment where its investment will be at least \$25,000 (except in the case of Proof of Concept investments discussed below).

Seed Fund Initial Investments as at 6 April 2011

As at 6 April 2011 the Seed Fund had made 56 initial investments ranging in value from \$10,000 to \$250,000. The average initial investment by SCIF across that portfolio of companies was approximately \$197,000 and the average amount of initial investment by private co-investors (alongside SCIF) in each company was approximately \$640,000.

Deployment of SCIF capital

It is important to note that after the initial investment of \$250,000 into a company has been made, SCIF's current policy is that it will look to invest the remaining \$250,000 of available investment funds into that business over the subsequent 2 - 4 years. This approach is based on the experience of NZVIF, both in relation to the Seed Fund and NZVIF's Venture Capital fund (established in 2002 and invested in 50 companies) that it is prudent to reserve the last part of available capital for further investment rounds rather than invest it all (or a considerable percentage) in the earliest years of an investment.

SCIF will take the following factors into consideration when determining how much to invest in later funding rounds:

- As a general rule, SCIF will look to simply maintain its pro rata shareholding
- The amount invested to date and the overall amount still available for investment
- The approach/investment strategy being taken by SCIF's co-investment partner
- The degree to which it is appropriate to hold back funds for future investment rounds

How SCIF's investment is applied to any particular company over a period of time is always something that is dealt with on a case by case basis. Partners should be aware though of the broad follow-on investment policy outlined above and open an early dialogue with SCIF around the likely implications of this for each company.

“Eligibility” Requirements

1. STAGES

To be eligible the company must be a “seed” or “start up” business. The definitions for stage of development of early stage companies set out in the Government’s mandate reflect standard venture capital terminology used internationally, and were drawn from a number of reputable international sources. The definitions are however subjective and the “start up” definition in particular has proved to be challenging in the past with the boundary between a “start-up” and “early expansion stage” company unclear. It is usually much clearer when a company is at the “seed” stage.

The “seed”, “start up” and “early expansion stage” definitions that SCIF uses as a starting point are as follows:

Seed

An investee company is at the seed stage of its development if the investment will enable development, testing and preparation of a product or service to the point where it is feasible to start business operations.

Start-up

An investee company is at the start-up stage of its development if the investment will enable actual business operations to get underway. This includes further development of the company’s product(s) and initial production and marketing.

Early expansion

An investee company is at the early expansion stage of its development if the investment provides capital to initiate or expand commercial production and marketing but where the company is typically or likely to become cash flow negative.

Where these definitions do not provide sufficient guidance however, NZVIF has developed a set of guidelines to assist in defining the stage of a company. These guidelines are based on the five years of experience from managing the VIF Venture Capital Fund and are focused in particular on addressing the “grey area” between start-up and early expansion stage.

The stage of a company must always be looked at on a case by case basis, so this is an area where it is particularly important to engage early with the SCIF team if there are any questions or concerns regarding “stage” eligibility.

2. ELIGIBLE INDUSTRY

The scope of “eligible” industries is very wide and the starting point is to reference what constitutes a SCIF “Ineligible Business” as defined in the Seed Fund’s mandate from Government. The Seed Fund cannot invest in any of the following business sectors:

- property development
- retailing
- mining
- hospitality
- financial intermediary

(but this does not preclude a business which markets a technology or other innovation to any of these industries).

In addition to this, the expectation is that the Seed Fund’s investment will involve, or advance the potential for, commercialisation of innovation. The Government’s mandate for the Seed Fund refers to innovation as involving “firms with high growth potential, innovative and technology-intensive firms seeking to develop unproven markets or technology, or firms with assets that are difficult to value.”

To a large extent, the NZVIF Investment Committee will rely on the relevant SCIF partner to clearly identify the extent to which a company possesses innovative or novel products or services. It is important to engage early with the SCIF team if there are any questions or concerns regarding “industry” eligibility.

3. NEW ZEALAND NEXUS

The potential investee company must have the requisite connection (or “nexus”) to New Zealand to qualify for SCIF funding. New Zealand nexus is established as long as the company in question has the majority of its employees (by number) and assets (by value) in New Zealand at the time of initial investment by SCIF. Once our initial investment is made we know that many portfolio companies will, over time, end up with significant offshore employees and operations in general and so that is not an issue from our perspective.

Overview of Key SCIF Deal Criteria

The “mandate” requirements set out above and the “in-house” investment guidelines and practices developed over time by the NZVIF management team and Investment Committee combine to form the overall framework for the SCIF investment process.

In simple terms, a proposed new investment must meet the following criteria to qualify for Seed Fund investment:

- **Eligibility:** the proposed investment meets the Eligibility Criteria set out above – i.e. it:
 - is within the investment amount limits;
 - is in seed or start-up stage;
 - has the necessary New Zealand nexus; and
 - is in an eligible industry.
- **Same investment terms:** the investment terms are the same in all respects for SCIF and the other investors.
- **Correct investment documentation:** the Investment documentation is based on the relevant industry standard template(s), amended as is appropriate for the proposed deal.
- **SCIF deal terms are included:** in particular for initial investments, there are small number of deal terms that are unique to SCIF and these must be included in the investment documentation (discussed in more detail below).
- **No conflicts:** the decision to proceed with the proposed co-investment and the terms of the co-investment have been determined on an “arms length” basis notwithstanding any association between the Company and the partner, the other investors or anyone connected to them. To the extent that any conflicts are identified, they must be disclosed and dealt with appropriately. Examples of situations that could give rise to relevant conflicts of interest are set out on page 14.
- **Investor representation on the Board:** Except where it may not be appropriate for a small initial investment (see Proof of Concept deal information below) an appropriate person will be appointed to represent SCIF as an active member of the investee company’s board. This person becomes SCIF’s “Investor Representative”. More details on this role are set out below.
- **Investment process:** the SCIF partner has applied “best practice” processes and standards to due diligence and valuation of the proposed investment and understands and complies with SCIF’s investment processes for that investment. These SCIF investment processes are summarised in deal flow diagrams for each of the main seed and start-up deal types (see more details on these below).
- **Other:** there are no other circumstances pertaining to the proposed investment which may be prejudicial to the reputation of NZVIF or the Seed Fund programme as a whole.

SCIF Specific Investment Terms

Reporting to the Government

SCIF is required to report to the Government on the economic impact of its investments (including revenue generated, number of employees and tax paid). The investment documents therefore need to permit SCIF to disclose confidential information to the Government with the proviso that NZVIF will only report and disclose that information on an aggregated basis and in a form that preserves the confidentiality of such information.

Quarterly Reports

It has always been a key objective of SCIF to ensure that there is a high standard of reporting to all investors, and the importance of this has certainly been reinforced by SCIF's experience during the first four years of the Seed Fund's operation. The investment documents therefore need to include a brief clause requiring the investee company to report, on a quarterly basis, in relation to its activities. Template reporting forms for this purpose are typically set out in a separate schedule in the investment documentation entered into at the time of the original investment.

A copy of our current quarterly report template can be found at <http://www.nzvif.co.nz/seed-co-investment-information.html>

Co-sale Rights

A clause should be included in the investment documentation which reflects the fact that SCIF invests alongside SCIF partners in all instances, and so it must have the ability, if it wishes to do so, to follow the actions of a partner who is selling all or part of their shares for any reason.

Matching Funding

SCIF's investment funds will not be paid over to the investee company until SCIF has received satisfactory evidence that an amount greater than or equal to the amount which SCIF is investing has been received from the other investors by or on behalf of the investee company.

Our preference with initial investments is that the matching capital from other investors will be collected in a central nominee bank account and then paid over in one amount to a law firm trust account pending deal completion or directly to the company in some instances (such as tranche payments following the initial investment).

SCIF normally requires confirmation of receipt of investment funds from the relevant law firm or (where relevant) a copy of the investee company's bank account clearly showing the receipt of investment funds from the other investors. The name(s) of the investors should also be clearly visible or marked (against the relevant investment amount(s)) on that bank statement

In this latter case, the situation can arise where (because of the use of nominee/trust accounts etc.) it will not always be clear on the face of the company's bank statement exactly who the funds have come from. Where this is the case, please ensure that you provide SCIF with:

A list of names of all of the investors who have paid funds to the company (including the exact amount paid noted against each of those names); and

Bank statement pages with entries that correspond to that list. Where necessary, this should include any necessary written notes against individual bank statement entries where the pay or details don't clearly

match the names on the member list (i.e. where a payment comes from a company or trust, or where a cheque has been deposited).

Ineligible Business

As noted above a NZVIF “Ineligible Business” means any business which principally involves one or more of property development, retailing, mining or hospitality or acting as a financial intermediary.

If NZVIF does not expressly consent to that change of business, provision must be made for the company to procure the purchase of SCIF's shares at a prescribed price.

Types of SCIF Investment Transactions

The main SCIF investment deal types are:

- Initial Investment – which will most commonly be in the form of either:
 - Ordinary Shares;
 - Preference Shares;
 - Convertible Loan (Long Form); or
 - Proof of Concept (Short Form Convertible Loan).
- Tranche Payment – occurs when an investment is split into 2 or more separate amounts payable to the company on the completion of agreed business milestones.
- Follow-on Investment – second and subsequent rounds of investment into the company in which SCIF participates.

Proof of Concept Investments (POC) (using a Short Form Convertible Loan)

The purpose of this form of investment is to provide a simple and cost effective way for SCIF partners (and SCIF investing alongside them) to put an initial small amount of money into a company and then work closely with, and monitor the progress of, that business with a view to then making further investments at a later stage.

The key ingredients of a POC deal are that:

1. There is no requirement for a Term Sheet to be negotiated and signed;
2. The investment is made using a standard Short Form Convertible Loan structure;
3. Generally, SCIF will usually only consider a co-investment where its investment will be at least \$25,000. However a smaller investment amount may be possible if the deal is kept very simple; and
4. SCIF will invest up to approximately \$150,000 of matching capital into a POC deal.
5. SCIF will require Quarterly Reports for POC portfolio companies

Deal Flow Diagrams

Deal flow diagrams for each of these main deal types are set out at <http://www.nzvif.co.nz/seed-co-investment-information.html>. These provide a quick visual overview of the main aspects of each deal type.

SCIF Investor Representative

As an integral part of the process of making each new investment a SCIF “Investor Representative” will be appointed. The only exception to this will be situations where it may not be appropriate for a small initial “Proof of Concept” investment.

In our experience it is crucial to identify the proposed Investor Representative as soon as possible in the deal process. Our Investor Representative accreditation process will typically consist of:

- The nominated person providing us with a full CV and any other relevant personal background information
- The nominated person completing a Statutory Declaration which will need to be witnessed by a lawyer. A copy of the the Statutory Declaration template can be found at <http://www.nzvif.co.nz/seed-co-investment-information.html>
- At least one meeting with the nominated person. As part of this meeting we will also confirm with them that they fully understand the obligations of the Investor Representative role and agree to undertake the role on our behalf.

As a passive investor, SCIF relies on this person to ensure that its investment interests are properly represented on a portfolio company board. For this reason it is important for SCIF to ensure that the Investor Representative is of good character, has the requisite business experience and has a sound business reputation. This person is usually, but not always, one of the other participating investors in the relevant investment. The Investor Representative will need to sign the standard form Investor Representative letter which outlines their obligations to SCIF in that role. A copy of this letter can be found at <http://www.nzvif.co.nz/seed-co-investment-information.html>.

As noted above, this is an important area to cover off with SCIF as soon as possible. If the intended Investor Representative has not already been approved by SCIF (for instance as part of the initial partner due diligence process or in relation to a prior co-investment) then SCIF will need to carry out a formal approval process for that person, which can take several weeks. It is also possible that the proposed Investor Representative will not be approved for some reason in which case our Co-investment partner will be asked to find another Investor Representative candidate.

SCIF Deal “Eligibility Certificates”

Every potential investment by SCIF (whether it be an initial investment or a follow-on investment) begins with a partner submitting the relevant eligibility certificate to us. The following current standard form Eligibility Certificate templates can be found at <http://www.nzvif.co.nz/seed-co-investment-information.html>:

- Initial Investment; and
- Follow-on Investment.

All sections of these Eligibility Certificates need to be completed and the more detail that can be provided the better from our perspective as a general rule. Any SCIF approval given for the “Eligibility” of either an initial or a follow-on investment is valid for 6 months. If an “Eligible investment is not completed within this time frame then a new eligibility certificate will need to be submitted seeking re-approval.

As part of the final completion process for each investment by SCIF the co-investment partner will also sign and return a “Co-investment Certificate”. Again, the current standard form Co-investment Certificate template can be found at <http://www.nzvif.co.nz/seed-co-investment-information.html>.

NZVIF Investment Committee Process

The Investment Committee for the Seed Fund meets regularly (generally on a weekly basis) to consider Eligibility Certificates for initial and follow-on investments.

INITIAL INVESTMENTS

When reviewing an Eligibility Certificate for an initial investment the key points being looked at by the NZVIF Investment Committee are as follows:

- **Stage:** The company is at the seed or start-up stage (see above);
- **Conflicts:**
 - that there are no conflicts of interest; and/or
 - that any potential conflicts of interest relating to the investment have been fully disclosed and appropriately dealt with. Examples of situations that could give rise to conflicts of interest include:
 - Fees/Other payments to certain shareholders or advisers only;
 - Any other investment terms that do not apply to all investors;
 - Existing shareholdings or other interests in the company;
 - The proposed Investor Representative for the deal is not sufficiently qualified and/or aligned with SCIF’s interests as an investor; and
 - The proposed investment is into a company that is an associate or related company to one that SCIF has already invested into;

- **New Zealand nexus:** The investment has a New Zealand nexus because the Company has the majority of its employees (by number) and assets (by value) in New Zealand at the time of initial investment; and
- **Eligible industry:** - the investment is in an eligible industry (see above).

FOLLOW-ON INVESTMENTS

When reviewing an Eligibility Certificate for a follow-on investment the key points being looked at by the NZVIF Investment Committee are as follows:

- Confirmation that the company is still trading in an eligible industry;
- Confirmation that no conflicts are apparent (see above);
- Confirmation that the investment matches SCIF's "matching" investment requirements - being that existing investors are intending to invest in this follow-on round;
- Confirmation that the company has made significant progress towards meeting its targets;
- Confirmation that as the investment allocation is pro-rata NZVIF's shareholder exposure will only marginally increase (if at all) by participating in this investment round;
- Confirmation that the investment terms are "market tested". This is a critical issue. If there is a material increase in share price in a follow-on round then new third party capital will be required to validate that pricing before SCIF can invest;
- The extent to which it is prudent for SCIF to reserve capital for further investment rounds; and
- Confirmation that there is no other reason that NZVIF believes the investment should not proceed for reputational or other reasons.

Carry Arrangements

Carry arrangements are discussed in a consultative manner with SCIF partners, and further details on options for such arrangements can be obtained at any stage from the SCIF team.

Transaction Fees

Where specifically agreed by SCIF, partners are able to receive one-off transaction fees for individual investments provided that:

1. The fee does not exceed 6% of the total amount invested in the company in the transaction;
2. Transaction fees across a co-investment (including follow-on rounds) alongside a partner do not exceed, in aggregate, 4% of the total amount invested by SCIF in that company; and

The fee paid by SCIF is not higher than that charged to the company by the partner in respect of investment by the other investors. In most cases, these fees are paid by the investee company out of the proceeds of the particular investment round.

We will also consider payment of a transaction fee to partners that is in addition to the amounts invested in a company as long as the fee does not exceed 6% of the total amount invested and, again, that the fees paid by other investors in the round at least match those paid by SCIF.

Industry Standard Investment Documentation

A comprehensive set of investment documentation has been developed for use when investing in seed and early stage companies in New Zealand. It is important to note that these are not just documents created by SCIF. Rather, they have been developed, agreed and improved-on by a range of Angel investment industry participants since the inception of SCIF.

SCIF does however require that these industry documents are used as the basis for investments that it is involved in. Not only does this simplify the SCIF investment process (saving time and money) but we also would like to see this documentation used across the wider seed and early stage investment market as a way of reducing overall transaction costs and helping to standardise best practice terms for this type of investment.

We encourage partners to start any potential investment process by reviewing the latest version of the relevant Deal Flow Diagram at <http://www.nzvif.co.nz/seed-co-investment-information.html>. When contemplating the terms of any deal it is important that SCIF is involved at an early stage as we will need to approve those as part of our investment process. Occasionally investments are presented to the SCIF for the first time with executed term sheets, and this does not work. In order to facilitate efficient review, investment documentation presented to SCIF for approval at various stages as the deal takes shape must be “marked-up” to show the variations and changes to previous versions. This benefits everyone by cutting down on transaction time and costs.

We have also found it very helpful at the early stage of deals for someone from SCIF to meet (in person or by phone) with the relevant partner and Investor Representative on the deal and spend time doing a “page turn” going through the draft investment term sheet/documentation. This not only enables the key deal ingredients to be discussed in detail but provides a really good opportunity to develop the relationship between these parties.

Appointment of Deal Lawyers

The intention is that wherever possible one lawyer should be appointed to represent all of the investors in a deal. Typically this will occur after a detailed term sheet has been agreed with the company, but the timing of the appointment does vary.

SCIF has a standard form lawyer engagement letter that can be used for this appointment. In the case of initial investments (or the payment of a first tranche of an initial investment), SCIF's expectation is that all investment funds will be paid into the deal lawyer's Trust Account and will be released from there to the investee company on completion of all investment conditions. The role and involvement of deal lawyers in SCIF deals is set out in more detail in the deal flow diagrams available for each of the key deal types - <http://www.nzvif.co.nz/seed-co-investment-information.html>.

Deal Due Diligence and Valuation

One of SCIF's core requirements is that partners exercise the degree of skill and care expected of a reasonably experienced and diligent early stage private equity investor in selecting, investigating and negotiating investments.

Without limiting that general requirement, partners are expected to undertake appropriate due diligence in respect of a proposed investment that includes an assessment of the company's valuation and the investment returns which are realistically achievable.

For each initial investment opportunity SCIF will need to see details of the valuation work that has been undertaken to satisfy itself that this has been done to an appropriate standard. Eligibility Certificates for both initial and follow-on investments contain a specific requirement for partners to provide a summary of the investment case work that has been done by the partner for a specific investment. In some situations this information will not be fully available when an eligibility certificate is submitted to SCIF (for instance where the actual structure or pricing of an investment round has yet to be finalised). Where this is the case the partner should simply note this and provide the relevant information to SCIF as and when it becomes available. What we are looking for though in relation to all investments is information pertaining to:

1. How the valuation of the company in a particular investment round has been determined;
2. What the company's capital requirements going forward will be and the plans in place to raise any subsequent rounds of capital; and
3. What is the current investment exit strategy and view of exit timing and value.

To help partners with this process the SCIF team has also developed an investment casing model that is based on the Venture Capital Method (VCM) of valuation. The VCM is perhaps the key valuation method used within professional U.S. and European angel groups and a relatively simple model to input and update.

Our recommendation is that partners use this model as a key basis for valuation work in relation to potential investments and we are also happy to assist partners to undertake this valuation work using this model. A current version of the VCM can be obtained from NZVIF at any stage.

SCIF Investment Casing Model

The VCM model works by calculating the required return for each dollar invested in a company and then deducting this total required return from an estimated exit value. The difference between the required return and the exit value is the equity component of the company and is attributable to the founding shareholders under the VCM model. By stepping backwards through the calculations, an initial pre-money valuation for the company that takes into account the requirement for future capital raisings can be calculated.

While the primary aim of this model is to assist in generating fair pre-money valuations for deal companies, the model is also useful throughout the life of an investment (as expectations for terminal value, date of exit, and forecast capital raisings change) to assist in determining the terms of future capital raisings.

One of the key benefits SCIF believes that this model provides is the requirement to rigorously analyse the valuation of the company from the outset. This is a requirement that we believe investors should

expect when investing in a company. If all investors have a clear idea of the path to exit, the targeted value at exit and the capital required to fund the company to exit (even though these may change over the company's life), we believe that investors will then have a greater ability to monitor the company's progress over its life and greater confidence to invest in both the current investment round and future investment rounds.

All of the standard form industry documents currently used by SCIF can be viewed and downloaded at <http://www.nzvif.co.nz/seed-co-investment-information.html>.

Our aim at SCIF is to ensure that all of these documents are current and kept completely up to date. As such, partners should ensure that they review and download relevant documentation directly from this section of the NZVIF website on a deal by deal basis.

DISCLAIMER

The deal documentation provided on the NZVIF website is intended to be used as a starting point for documenting proposed investment terms. The terms set out in these documents may not be suitable for a particular transaction. NZVIF does not make any representations as to the suitability or otherwise of these documents for any particular transaction, or that NZVIF will enter into any arrangement based on these documents.